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Supreme Court of the
UNITED STATES

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CHARLES EUGENE BADGLEY
OLEANDER

In the Supreme Court of the United States

OCTOBER TERM, 1940

CONSOLIDATED ROCK PRODUCTS CO., AND EDWARD E.
HATCH ET AL., COMPOSING THE PREFERRED STOCK-
HOLDERS COMMITTEE OF CONSOLIDATED ROCK PROD-
UCTS CO., PETITIONERS

v.

E. BLOIS DU BOIS

F. B. BADGLEY ET AL., COMPOSING THE UNION ROCK
COMPANY BONDHOLDERS' PROTECTIVE COMMITTEE,
ET AL., PETITIONEES

v.

E. BLOIS DU BOIS

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION
AS AMICUS CURIAE

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E. BLOIS DU BOIS

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v.

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OPINIONS BELOW

The District Court rendered no opinion; its findings and conclusions appear at R. 219-265. The

opinion of the Circuit Court of Appeals (R. 365-380), as modified (R. 382), directing reversal of the order of the District Court is reported in 114 F. (2d) 102. An earlier opinion of the Circuit Court of Appeals directing affirmance of the order of the District Court was withdrawn by the court (R. 364); that opinion is not a part of the record, but it may be found in 107 F. (2d) 96, advance sheets.

JURISDICTION

The decree of the Circuit Court of Appeals reversing the order of the District Court was entered on June 19, 1940 (R. 381). Petition for rehearing was denied by the Circuit Court of Appeals on August 5, 1940 (R. 383). The petition for a writ of certiorari in No. 400 was filed on September 6, 1940, and the petition for a writ of certiorari in No. 444 was filed on September 18, 1940. Certiorari was granted in both cases on October 28, 1940. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The Circuit Court of Appeals reversed an order of the District Court confirming a plan of reorganization for Consolidated Rock Products Company and its two wholly-owned subsidiaries, Union Rock Company and Consumers Rock and Gravel Company, Inc. The questions are:

(1) Whether the court below correctly held that the findings of the District Court on the question of the valuation of the properties of these companies were inadequate.

(2) Whether under the rule enunciated in *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, the plan of reorganization is unfair and inequitable to the bondholders of Union and Consumers because the stockholders of Consolidated are permitted to participate although the bondholders do not receive fully compensatory treatment for their claims.

(3) Whether the plan is, as a matter of law, unfair and inequitable to the bondholders of Union and Consumers *inter se* on the ground that the bondholders of each company are required to share the property securing their bonds with the bondholders of the other company, even though they receive compensation in the form of interests in other property.

STATUTE INVOLVED

The statute involved is Section 77B (f) of the Bankruptcy Act (11 U. S. C., Sec. 207 (f)), the pertinent portion of which is as follows:

After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible * * *

Other sections of the Bankruptcy Act herein-after cited are printed in the Appendix, *infra*, pp. 58-59.

STATEMENT

These proceedings were instituted on May 24, 1935, by the filing of separate voluntary petitions under Section 77B of the Bankruptcy Act by Consolidated Rock Products Company (hereinafter called Consolidated) and by its two wholly owned subsidiaries, Union Rock Company (hereinafter called Union) and Consumers Rock and Gravel Company, Inc. (hereinafter called Consumers) (R. 267). Consolidated has been in possession of all the properties of the three companies throughout the proceedings (R. 267-268). No trustee has been appointed for any of the companies.

Capital Structure and Relation between the Companies—Consolidated was organized in 1929 to acquire the outstanding capital stock of Union and Consumers, which were at that time competitively engaged in the business of mining, processing and marketing rock, sand, and gravel in southern California. Both Union and Consumers then had outstanding separate bond issues secured by trust indentures on their respective properties (R. 235). There are now outstanding in the hands of the public \$1,877,000 of Union bonds on which interest has been in default since March 1, 1934. This interest aggregated \$403,555 as of April 1, 1937, the effective date of the plan. There are now

outstanding in the hands of the public \$1,137,000 of Consumers' bonds, on which interest has been in default since July 1, 1934. This interest aggregated \$221,715 as of April 1, 1937. (R. 189, 191-192.)

To secure funds for the acquisition of Union's and Consumers' stocks, Consolidated issued its own preferred and common stock (R. 234). Consolidated now has outstanding 285,947 shares of preferred stock without par value but with a liquidation preference of \$25 per share plus accrued dividends, and 397,455 shares of common stock without par value (R. 25, 136).

Upon acquiring control of Union and Consumers, Consolidated designated their directors and officers (R. 236). It then caused the subsidiaries to execute an operating agreement with it (R. 236) pursuant to which Consolidated took over the possession, operation, management and financing of their properties.¹ Under the terms of the agreement, Consolidated undertook to maintain the properties of the subsidiaries in first class condition; to keep proper records of all transactions between the parties, including proper entries concerning depreciation, depletion, amortization and obsolescence in compliance with the trust indenture.

¹ The agreement also covered the properties of Reliance Rock Company, a wholly owned subsidiary of Union (R. 236, 233-234). Legal title to all the properties of Union, Consumers, and Reliance, except current assets, was formally retained by these companies (R. 164).

tures of the subsidiaries; to pay them the amounts necessary to enable them to meet the interest and sinking fund provisions of their trust indentures; and to carry out the covenants of the trust indentures (R. 165-168). Consolidated was to retain all the net revenues of the properties that might remain (R. 171).

Consolidated also agreed to credit the current accounts of the subsidiaries with items of depreciation, depletion, amortization and obsolescence (R. 171). Upon termination of the agreement, the properties were to be returned and a final settlement of accounts made, including payment by Consolidated of the items of depreciation, depletion, amortization, and obsolescence credited to the subsidiaries (R. 174). The agreement provided that it was made for the mutual benefit of the parties thereto and not made "for the benefit of any third person as that term is used in Section 1559 of the Civil Code of the State of California" (R. 174-175). It further provided that any party might withdraw from the agreement upon 30 days' notice, and that the agreement was to terminate when such notice was given by all of the subsidiaries to Consolidated or by Consolidated to all of the subsidiaries R. 173-174).

On February 16, 1933, Consolidated accomplished a purported modification of the operating

agreement (R. 176, 237) through an instrument signed by the president and secretary of Consolidated; who also signed as president and secretary of each of the subsidiaries (R. 182). This modification agreement provided that the depreciation to be credited to the subsidiaries by Consolidated for the entire period of the operating agreement, beginning retroactively as of the execution of the original operating agreement, should be credited only upon the termination of the agreement. The amount of the credit was to be arrived at on the basis of retroactive appraisals, made after the termination of the agreement, of the value of the properties as of April 1 of each year. The provision of the original agreement for withdrawal of any party upon 30 days' notice was eliminated and it was provided instead that, except in the case of default, the agreement was to run for five years from the date of the modification, with an option in Consolidated to extend the agreement for a further term of five years upon one year's written notice. In the event of default by Consolidated as to any subsidiary, that subsidiary could terminate upon sixty days' notice in writing. Consolidated was under no obligation to pay any amounts for depreciation until termination of the agreement, and then had the privilege, by paying an additional five per cent penalty, of paying 25 per cent of the amount of the depreciation credit in

ten equal annual installments, and the remaining 75 per cent at the end of the tenth year from the date of termination of the agreement (R. 178-181). Under the provisions of the modification agreement, therefore, it was possible for Consolidated to avoid determination of the amount of the depreciation credit until retroactive appraisals were made ten years after execution of the agreement, and to avoid payment of 75 per cent of the amount so determined for 20 years after execution of the agreement.

After the execution of the original operating agreement, Consolidated operated the properties of all the companies as though there had been an actual consolidation thereof under one ownership although the corporate existence of the subsidiaries was maintained (R. 140-141, 241). With a decline in the volume of business and a consequent contraction of operations, equipment and material from nonoperating properties were used to supply shortages in operating properties without regard to original ownership, so that, as the District Court found, it became impossible to determine accurately what assets were subject to the indentures of each of the subsidiaries (R. 241-242; 279-280). Consolidated's own equipment purchased both at the time of its organization and subsequently to replace worn-out equipment of all the companies, was likewise intermingled with the

properties of the subsidiaries (R. 139-140, 149-150, 241-242, 316). Consolidated's vice-president testified that the properties purchased by Consolidated had an original cost of \$860,007.39 and a net value, as of September 30, 1937, of \$296,465.58 (R. 286).

Consolidated has never undertaken to have the subsidiaries' properties appraised, even though defaults in the payment of principal and interest on both Union and Consumers bonds occurred in 1933 and 1934 (R. 241), the companies have been in reorganization since May, 1935 (R. 267), and the modification agreement expired according to its terms in February 1938.² Consolidated's books have been kept in accordance with the terms of the original operating agreement and no attempt has been made to record any revised depreciation charges (R. 236, 280-1, 299). They show a net indebtedness to Union and Consumers, as of June 30, 1938, of over \$5,000,000 (R. 314-319).

Valuation.—The District Court did not find specific values for the properties of either Consoli-

² The modification agreement provided for earlier termination in the event of default in any of Consolidated's covenants, including the covenant to pay the sums necessary to meet interest and sinking fund requirements on the subsidiaries' bonds (R. 167-168, 181). However, under the terms of the agreement, termination could be effected only by notice from the subsidiaries to Consolidated. The subsidiaries were at all times under the control of Consolidated, and no such notice was given.

dated, Union or Consumers or for the properties of the enterprise as a whole. The court did find, generally; that the value of the assets of the combined enterprise exceeded the aggregate claims of the bondholders, including interest to April 1, 1937, but was less than the amount of such claims plus the claims of Consolidated's preferred stockholders, including dividend accumulations (R. 245). The court further found that the value of the assets subject to the respective liens of the Union and Consumers bondholders was, in each case, less than the principal and interest due on their bonds (R. 245). The court below thought this finding to be inconsistent with the finding that the assets of the three companies have been so commingled that identification thereof is impossible (R. 374).

Three witnesses testified concerning values, and the valuations given by them are tabulated in the opinion of the court below (R. 371). The average of the valuations, which is apparently accepted as correct by petitioners (Br. 31),³ shows Union with assets worth \$2,202,733, as against a bonded indebtedness, including interest, to April 1, 1937, of

³ All references to petitioners in this brief, unless otherwise expressly stated, are to petitioners in No. 400. As pointed out below (p. 16), the petitioners in No. 444 have raised only the third of the questions presented and the Commission is in agreement with their position on that question.

\$2,280,555, and Consumers with assets worth \$1,-151,033, as against a bonded indebtedness, including interest to April 1, 1937, of \$1,358,715. On the basis of similar averaging of the testimony of witnesses (R. 281-282, 290), petitioners assert that the value of Consolidated's assets is \$859,784 exclusive of goodwill and trade names, which are arbitrarily valued at \$500,000 on the basis of the testimony of Mitchell, Consolidated's vice president (Br. 26, 27, 30; R. 282).

The testimony upon which petitioners rely for these valuation figures was apparently based on physical factors without reference to data concerning earning power. This testimony conflicts with the consolidated balance sheets furnished by Consolidated, which show the enterprise to be insolvent in the bankruptcy sense (R. 314). It should also be noted that, except for the year 1929, Consolidated showed no net operating profit, after bond interest and provision for depreciation and depletion, in any year during the period from its organization to the date of the hearings on the plan (R. 190-191). Considering the results of operations before bond interest but after depreciation and depletion, Consolidated had a loss of \$1,282,388 for the eight and one-half years from April 1, 1929, the effective date of the operating agreement, to September 30, 1937 (R. 183-191). Except for five quarterly dividends in 1929 and 1931 on the preferred stock of

Consolidated, no dividends have been paid on either its preferred or common stock (R. 240, 280).

The Plan.—The District Court accepted the conclusion of the parties, including the bondholders' committees, that it was necessary and desirable to maintain operations of the three companies on a unified basis (R. 226, 241-242, 244). Accordingly, the plan of reorganization, filed for all three companies, provides for the formation of a single corporation to acquire all the properties of the companies (R. 26). The securities of the new corporation are to be distributed to existing claimants as follows: Union and Consumers bondholders will receive 50 percent of the principal amounts of their claims in 5 percent cumulative income bonds, secured by a mortgage on all of the property of the new corporation, and 50 percent in 5 percent \$50 par value preferred stock. Thus, Union bondholders, for their claims of \$2,280,555, will receive \$938,500 of new income bonds and the same amount of new preferred stock, and Consumers bondholders, for their claims of \$1,358,715, will receive \$568,500 of new income bonds and the same amount of new preferred stock (R. 27-30). These securities will constitute all of the new bonds and preferred stock to be issued.

The new income bonds, which will mature in twenty years, will bear interest at the rate of 5 percent if earned, and cumulative if not paid (R. 35, 42-43). The new preferred stock will carry a dividend of 5 percent per annum, noncumulative

until the retirement of the bonds except to the extent that net income is available therefor, and thereafter cumulative (R. 47).⁴ In addition, each share of new preferred stock will carry with it a warrant for the purchase of two shares of new \$2 par value common stock at prices ranging from \$2 per share within six months after issuance to \$6 per share during the fifth year after issuance (R. 28-30). No further recognition is given to the old bondholders for the principal and interest of their claims.

The preferred stockholders of Consolidated will receive one share of the new common stock for each share of the old preferred, a total of 285,947 shares of the new common (R. 27, 31). A warrant to purchase one share of the new common at \$1 within three months after issuance will be issued to the common stockholders of Consolidated for each five shares of the old common (R. 31). An aggregate of 79,491 shares of new common will be authorized and reserved for the exercise of the

*The bonds and preferred stock to be issued to Union and Consumers bondholders, respectively, will be in separate series designated as Series U and Series C (R. 28-30, 40-41). The net income of the new corporation will be divided into two equal parts. Each part will be used to pay successively, with respect to the bonds and preferred stock of each series, interest on the bonds, sinking fund payments thereon, dividends on the preferred stock, and sinking fund payments for the preferred; any income remaining thereafter will be available for general corporate purposes (R. 33-34). Proceeds from the sale of nonessential properties will be used to retire the bonds and preferred stock (R. 43).

warrants issued to the old common stockholders; an additional 60,280 shares of new common will be authorized and reserved for the exercise of the warrants to be attached to the new preferred stock (R. 27). The total number of shares authorized to be issued, therefore, is 425,718 (R. 27).

The new preferred stock, to be issued to the old bondholders, will be entitled to elect four of the nine directors of the new corporation (R. 49). The remaining five directors will be elected by the new common stock (R. 49), the majority of which will be held by the old preferred stockholders of Consolidated even if all warrants are exercised. Only upon the failure to pay interest on the bonds in prescribed amounts will control of the new company pass to the old bondholders (R. 49).

The plan further provides for the cancellation of \$102,500 face amount of Union bonds and \$63,500 face amount of Consumers bonds held by Consolidated (R. 55). The stock of the subsidiaries held by Consolidated and the net claims of the subsidiaries against Consolidated aggregating over \$5,000,000 will also be cancelled.

None of the companies is indebted to general creditors in any significant amount (R. 248, 314-319) and the plan provides that the claims of such creditors shall either be paid in full or assumed by the new corporation (R. 32-33).

The treatment to be accorded existing securities under the plan is shown in tabular form below.

The table does not list the warrants to be issued or the intercompany claims to be cancelled.

Existing securities	Proposed new securities					
	First mtrize. 5% cum. income bonds	Pfd. stock \$50 par value 5% non-cum.		Common stock, \$2 par value		
		Shares	Par value	Shares	Par value	
Union 1st Mortgage 6% Serial Bonds	\$1,877,000.00	938,300	18,770	\$938,500		
Accrued Interest to April 1, 1937	\$403,555.00					
Consumers 1st Mortgage 6% Bonds	\$1,137,000.00	568,500	11,370	568,500		
Accrued Interest to April 1, 1937 ¹	\$221,715.00					
Consolidated \$1.75 Cum. Pfd., no par value, liquidation preference, \$25 ²		285,947			285,947	\$571,894
Consolidated Common, no par value		397,455				
Total		1,507,000	30,140	1,507,000	285,947	571,894

¹ The proposed effective date of the plan.

² The liquidating preference of these shares aggregates \$7,148,675, exclusive of accumulated and unpaid dividends.

* Shares.

Disposition of the Plan in the Lower Courts.—The plan was confirmed by the District Court on September 8, 1938 (R. 231). Respondent E. Blois DuBois, a holder of both Union and Consumers bonds, objected to the plan and appealed from the order of confirmation (R. 349). On November 4, 1939, the court below rendered an opinion affirming the action of the District Court (see 107 F. (2d) 96, advance sheets). After the decision of this Court in *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, the court below granted a petition for rehearing and ordered its

first opinion withdrawn (R. 363-364). Upon the rehearing, the order of confirmation was reversed (R. 365, 381, 382).

Petitioners in this Court.—The petitioners in No. 400 are Consolidated and a committee of its preferred stockholders. They seek to have the decree of the court below reversed and the order of the District Court confirming the plan affirmed. The petitioners in No. 444 are the protective committees for the Union and Consumers bondholders. They seek reversal of the decree below only in so far as it holds the plan to be unfair and inequitable to the bondholders by reason of failure to allot them full priority in the particular assets subject to their respective liens.

Participation of the Securities and Exchange Commission.—The Securities and Exchange Commission first appeared in the present case by filing a brief *amicus curiae* upon the rehearing in the court below. After entry of the decree of reversal, the Commission filed a notice of appearance in the District Court pursuant to Sections 208 and 276. c. (2) of Chapter X of the Bankruptcy Act, as amended. The Commission is now participating as a party in the proceeding before the District Court.

SUMMARY OF ARGUMENT

1. The findings of the District Court are inadequate to permit a determination that *any* plan of

reorganization for the three companies here involved is fair and equitable. The court left undetermined the validity and value of the claims, aggregating over \$5,000,000, of Union and Consumers against Consolidated, and no precise findings were made as to the value of the assets of any of the companies, even apart from these claims, or of the enterprise as a whole. An examination of the record reveals that no adequate valuation testimony was introduced upon which the necessary findings could properly have been made. Accordingly, the court below was clearly correct in reversing the order of confirmation and directing that a further investigation of value be made.

2. Even on the present record, however, it is clear that the plan of reorganization now before the Court is unfair and inequitable to the Union and Consumers bondholders. On the basis of petitioners' valuation figures, the value of the assets subject to the liens of the bondholders is only about \$300,000 less than the face amount of the bonds outstanding in the hands of the public, plus interest accrued to April 1, 1937. Yet the face amount of the new income bonds and preferred stock which the bondholders are to receive is \$625,000 less than their admitted claims. Moreover, these new securities are of a definitely inferior grade. There is no reasonable prospect that these securities will be of a value equivalent to

their face amount upon termination of the proceedings or reasonably soon thereafter, and they cannot, therefore, be regarded as satisfying even *pro tanto* the bondholders' claims.

Petitioners attempt to justify the participation in the plan of Consolidated's preferred stockholders, despite the reduction and impairment of the rights of the bondholders, on the ground that Consolidated has assets worth \$859,000 which, they contend, are not subject to the bondholders' claims. The answer is twofold. In the first place, the record clearly establishes that Union and Consumers have valid and enforceable contractual claims against Consolidated which must be satisfied out of Consolidated's assets before its stockholders may participate at all, and that these claims are more than sufficient in amount to provide full compensation for the bondholders. In the second place, in view of the intermingling of the properties by Consolidated itself and the appropriation of the income thereof by Consolidated under the operating agreement, the whole enterprise must necessarily be regarded as a unit. So regarded, it is plain that the claims of the bondholders must receive full priority out of all the assets owned by the enterprise before any interest therein is accorded to the stockholders.

3. Although, for the reasons stated above, we believe that the court below correctly reversed the order of the District Court confirming the plan,

we believe the court erred in its further holding that the plan is unfair and inequitable as a matter of law simply because it permits Union's bondholders to share in Consumers' assets and Consumers' bondholders to share in Union's assets. This holding was apparently founded on the view that a class of claimants with a lien on particular properties must receive fully compensatory treatment out of those properties and may not as a matter of law receive less than fully compensatory treatment out of those properties even though it is adequately compensated with an interest in other properties. This ruling, unless reversed, will make impossible the formulation and consummation of a plan of reorganization which provides for unified operation of all the properties by a new corporation and for the satisfaction of the claims of the bondholders through their participation in securities covering all the properties of the new corporation.

The decision in *Case v. Los Angeles Lumber Co., Ltd.*, 308 U. S. 106, furnishes no support for the decision below in this regard. The rule of full priority is not violated merely by the fact that lienors surrender their priority to, or share it with, persons who contribute new funds to the enterprise. The present situation is similar, except that the contribution made by each group of lienors for the right to share in the assets contributed by the other group is made in property rather than in money.

ARGUMENT

I

THE DECISION OF THE COURT BELOW AND THE POSITION
OF THE COMMISSION WITH RESPECT THERETO

Upon the rehearing in the court below, the Commission contended that the order of confirmation should be reversed because the plan of reorganization failed to meet the requirements of the rule enunciated in *Case v. Los Angeles Lumber Products Co., Ltd.*, *supra*. The basis of the contention was that the plan did not provide fully compensatory treatment for the bondholders of Union and Consumers to the extent of the value of the assets subject to their claims, and yet allowed participation in those assets by the preferred stockholders of Consolidated whose position was junior to that of the bondholders. The court below held that the findings of the District Court were inadequate to allow final disposition of this contention, since the findings failed to show the value of disputed claims, aggregating over \$5,000,000, which Union and Consumers had against Consolidated. Moreover, the court held that judgment in this matter was hampered by the inadequacy and inconsistency of the findings with respect to the values of the properties subject to the lien of the bonds issued by Union and Consumers, and the value of any assets of Consolidated (R. 373-374, 382-383).

The court might have stopped at this point and remanded the case to the District Court for further

findings. Instead of so doing, however, it simply observed (R. 374) that "since the plan proposed, we think, is unfair as a matter of law for reasons hereafter stated, we assume that both matters mentioned will be satisfactorily disposed of upon remand of the cause."

The reasons that the court believed the plan to be unfair as a matter of law were then stated by it in the following words (R. 377):

The trial court found that the property of Union covered by the trust indenture was insufficient to pay the principal and accrued interest of the bonds issued by Union, yet the Union bondholders are deprived of their right to full priority against Union's assets, since Consumers' bondholders and debtor's preferred stockholders are given an interest in Union's property. Likewise, the trial court found that the property of Consumers covered by the trust indenture was insufficient to pay the principal and accrued interest of the bonds issued by Consumers, yet Consumers' bondholders are deprived of their right to full priority against Consumers' assets, since Union bondholders and debtor's preferred stockholders are given an interest in Consumers' property. Exactly in point, as to facts, is *Case v. Los Angeles Lumber Co., supra.* Since the order must be reversed on the ground that the bondholders have not been accorded full priority, it is unnecessary to discuss other charges of unfairness in the plan, some of which appear to be sound.

As we understand this portion of the opinion, the court below held that a class of claimants with a lien on particular properties must receive fully compensatory treatment out of those properties and may not *as a matter of law* receive less than fully compensatory treatment out of those properties even though it is adequately compensated with an interest in properties subject to the lien of another class of claimants.

⁵ This portion of the opinion is not entirely clear insofar as it declares the plan to be unfair to the bondholders because the preferred stockholders of Consolidated are given an interest in the assets securing the bonds. The court may have meant simply that the participation of the preferred stockholders in the plan was unfair to the bondholders because the bondholders had not received full priority; it may have meant, on the other hand, that the preferred stockholders should not have been allowed to share in the particular assets securing the bonds because the bondholders had not received fully compensatory treatment out of those assets.

But whatever the court may have meant by its reference to the preferred stockholders, it plainly intended to announce the principle of law stated in the text insofar as it held the plan unfair as a matter of law because each group of bondholders was required to share its security with the other group of bondholders. No other construction can be given to the words (R. 377) that "the Union bondholders are deprived of their right to full priority against Union's assets, since Consumers' bondholders * * * are given an interest in Union's property" and that "Consumers' bondholders are deprived of their right to full priority against Consumers' assets, since Union bondholders * * * are given an interest in Consumers' property." That the mention of the interest given to each group of bondholders in the assets of the other group was not inadvertent is shown by the fact that the court below denied a motion, joined in by all of the parties, to modify this paragraph of the opinion

This holding we believe to be plainly erroneous for the reasons stated in Point IV, *infra*, pp. 47-51. Consequently, although we urge affirmance of the decree below, we also urge that the mandate of this Court should issue in such form as to permit the District Court to proceed further in the reorganization without regard to this holding.

The grounds upon which we urge affirmance of the decree below are: (1) that the findings of the District Court on the question of valuation are insufficient to permit a determination that *any* plan of reorganization for these companies is fair and equitable; and (2) that, even on the basis of the present record, it is evident that *this* plan of reorganization is unfair and inequitable to the Union and Consumers bondholders.

II

THE FINDINGS OF THE DISTRICT COURT ARE INSUFFICIENT TO PERMIT DETERMINATION THAT ANY PLAN OF REORGANIZATION IS FAIR AND EQUITABLE

It is manifest, we believe, that before any plan of reorganization for the three companies here involved can properly be confirmed as fair and equitable, there must be some adequate determination of the value of the enterprise as a whole and of the assets belonging to each company. If Consolidated has no assets which are not subject to a valid claim

so as to delete references to the interest given to each group of bondholders in the property securing the claims of the other group of bondholders (R. 382-383).

of Union and Consumers, Consolidated's stockholders are obviously not entitled to participate in the reorganization unless Consolidated, as holder of all the stock of Union and Consumers, has an equity in their assets remaining after full priority is accorded to the Union and Consumers bondholders. The existence or nonexistence of such equity cannot be determined without ascertaining the value of the business as a going concern. Similarly, if Consolidated has assets which are not subject to a valid claim of Union and Consumers, those assets must be valued in order to determine the extent to which their existence may justify participation in any plan by Consolidated's stockholders. And in either situation, it is necessary to value Union's and Consumers' assets in order to determine whether the treatment accorded to the bondholders of each company is fair to them *inter se*.

As the court below held, the findings of the District Court are totally inadequate on these fundamental issues. Not only did the court leave undetermined the validity and value of claims, aggregating over \$5,000,000, which Union and Consumers have against Consolidated, but it made no findings concerning the value of the assets of the companies apart from these claims. And examination of the record reveals that no adequate valuation testimony was introduced upon which the necessary findings could properly have been made.

1. With respect to Union and Consumers, the District Court found merely that the present fair

value of all of the assets "admittedly" subject to the trust indentures securing their respective bond issues "is insufficient to pay the par value of the bonds, plus accrued interest" (R. 245). This finding, as the court below pointed out (R. 374), is not easy to reconcile with the further finding that the assets of the three companies have been so commingled that identification of the assets belonging to each is impossible (R. 241-242). Moreover, the District Court failed to find the extent to which the bonded indebtedness of each company, plus accrued interest, exceeded the value of the mortgaged assets, and it failed to determine whether or not Union and Consumers had any assets not subject to the trust indentures, and, if so, the value of such assets. Had such a determination been made, as it should have been, it would necessarily have involved a determination of the validity and value of the claims of Union and Consumers against Consolidated.

2. So far as Consolidated is concerned, there is no finding whatever as to the value, if any, of its assets. Instead of making such a determination, the District Court found only that the value of the assets of all three companies, if operated as a unit, was in excess of the total bonded indebtedness, plus accrued interest, although not in excess of the bonded indebtedness, plus accrued interest, and the liquidation preferences on Consolidated's preferred stock, including accrued divi-

dends (R. 245). It should be noted that this general finding of the solvency of the enterprise as a whole is inconsistent with the consolidated balance sheet filed by Consolidated itself (R. 314), which shows the enterprise to be insolvent. In any event, a mere conclusion that the enterprise as a whole is worth more than the amount of the mortgage debts is not sufficient; a more precise determination of value must be made so that a conclusion may be reached as to the proper allocation of securities between bondholders and stockholders.

3. In our view, the present record does not contain sufficient evidence upon which adequate valuation findings could have been made. Three valuation witnesses were called; of these three witnesses, referred to by the petitioners as "independent" (Br. 19), two are present officers of Consolidated, and the other is a former employee of Union (R. 279, 290-291). It is apparent that all three reached their conclusions as to value on the basis of physical valuations of the assets (R. 281-282, 290, 291-292).

The record contains no testimony concerning the estimated prospective earnings of the enterprise and no attempt was made to value the enterprise by the capitalization of such prospective earnings. The absence of such evidence, in and

* Rogers testified that Union could earn interest on a valuation of \$7,000,000, although the present value of its physical properties was \$2,318,000. As to this \$7,000,000 figure, the Special Master said, "The evidence does not warrant a finding of this valuation" (R. 151).

of itself, makes the record inadequate for any determination as to the fairness of any plan that may be presented. This is so because the proper method for estimating the value of any going concern is to capitalize prospective earnings at a rate appropriate in view of the risks inherent in the business. This was recently recognized by this Court in *Palmer v. Connecticut Ry. & Lighting Co.*, No. 38, this Term, decided January 6, 1941; it has similarly been recognized by the lower federal courts and by the leading text writers on valuation problems.⁷

The necessity for a thorough inquiry into the prospective earning power of the enterprise involved in the present case is emphasized by its poor earnings record in the past, which the valuation witnesses appear to have entirely disregarded. The record shows that the business has lost money in every year from 1930 through 1937 after interest and allowance for depreciation and depletion expense and taxes. Considering the results of operation before bond interest but after allowance for depreciation and depletion, the business lost \$1,282,388 in the eight and one-half years from

⁷ *In re Wickwire Spangler Steel Co.*, 12 F. Supp. 528, 533 (W. D. N. Y.); *In re Consolidation Coal Co.*, 11 F. Supp. 594, 597 (Md.); *In re Pittsburgh Hotels Corporation*, 17 F. Supp. 949, 951 (W. D. Pa.); Bonbright, *Valuation of Property* (1937), Vol. 2, pp. 875-881, 883-893; Dewing, *The Financial Policy of Corporations* (3d ed. 1934), p. 140; Finletter, *The Law of Bankruptcy Reorganization* (1939), pp. 557-568; cf. *Atlanta, B. & C. R. Co. v. United States*, 296 U. S. 33, 38.

April 1, 1929 to September 30, 1937 (R. 183-191).⁸ In the light of this poor earnings record, it seems difficult to justify the value of over \$4,000,000 ascribed to the properties by petitioners, on the basis of the testimony of the valuation witnesses (Pet. Br., pp. 26-27, 30-31); to justify such a valuation on the basis of a capitalization of earnings, the enterprise would have to have an operating profit, after all expenses except bond interest, of over \$400,000 a year, even assuming the application of a 10% capitalization rate.

4. In this state of the record, we believe that the court below correctly held that "precise findings as to values must be made" for "a complete determination as to the fairness of any plan" (R. 380). We also believe that the court below properly left to the discretion of the District Court the question of whether an "appraisal" of the properties should be made for this purpose (R. 380). Certainly there is no place in most reorganization cases for an "appraisal" of a going concern consisting merely of the sum of values assigned to individual assets of the concern without regard to the earning power of the enterprise as a whole. But "appraisal" in the sense of a critical consideration of the nature and condition of these assets is, of course, an essential part of an enterprise valuation based on prospective earnings. In our view, no

⁸ It is impossible in the present state of the record to determine what allowances for depreciation and depletion must be made in the future.

adequate judgment may be formed on the present record as to the degree of inquiry necessary into the nature and condition of the assets in this case in connection with a valuation based on earnings, and the question of an "appraisal" in this respect was, therefore, properly left for decision by the District Court.⁹

III

THE PLAN OF REORGANIZATION NOW BEFORE THE COURT IS UNFAIR TO THE BONDHOLDERS OF UNION AND CONSUMERS

Although, for the reasons stated above, we believe the court below correctly held that the findings of the District Court as to the valuation of the properties are inadequate affirmatively to establish the fairness of *any* plan of reorganization that might be proposed for these companies, we think it plain, even on the basis of the present record, that *this* plan of reorganization does not comply with the requirements of the statute.

⁹ There would remain also to be considered in the District Court an appropriate formula for the ascertainment and valuation of the respective assets of Union and Consumers, in order to determine the fairness of the treatment afforded their bondholders *inter se*. Unlike the valuation of the enterprise as a whole, the valuation of Union and Consumers primarily on an earnings basis presents difficulties because of the manner in which these companies have been operated since 1929 (R. 238), the commingling of their assets, and the fact they have no individual earnings record.

A. THE TREATMENT ACCORDED TO BONDHOLDERS UNDER THE PLAN

In order to make the following discussion specific we shall use the values for tangible assets used in petitioners' brief. Based upon the average of the estimates contained in the testimony, petitioners treat Union's assets as worth \$2,202,733, Consumers' assets as worth \$1,151,033 and Consolidated's tangible assets (including all current assets of the enterprise) as worth \$859,784 (Br. pp. 26-27, 30-31). This gives a total value for the enterprise of approximately \$4,213,000.¹⁰

We do not concede by using these figures that the record contains satisfactory evidence from which such values can be found to exist. We emphasize, too, that the following discussion of the unfairness of the plan does not depend on any exact assumptions as to value, for the unfairness rests in the inadequacy of the securities given to the bond-

¹⁰ In the following discussion we disregard the value of \$500,000 ascribed by Mitchell to the good will of the enterprise (R. 282). This figure appears to be wholly arbitrary, particularly in the light of the earnings record (see pp. 11, 27, *supra*), the fact that only five quarterly dividends on the preferred stock were ever paid (in 1929 and 1931), that no dividends have ever been paid on the common stock, and that the bonds of the subsidiaries have been in default since 1933 and 1934. In any event, for the reasons discussed below at pages 43-44, we believe that, if good will is to be separately included as an element of value in determining the value of the properties, it should be apportioned among the several companies constituting the enterprise rather than be considered as an asset of Consolidated alone. See in this connection R. 147-148.

holders. Such inadequacy would exist irrespective of the precise values which the assets of any of the companies may be found to have.

Against the assets thus valued at \$4,213,000 stand prior claims of the bondholders aggregating \$3,640,000, representing the principal and interest of their claims as of April 1, 1937. The interest claims, amounting to \$625,000 or about 17% of the bondholders' total claims, are entitled to the same priority as the principal. *In re Barclay Park Corp.*, 90 F. (2d) 595 (C. C. A. 2d); cf. *American Iron and Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U. S. 261, 266-267; *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106. All of the bondholders' claims are now due and owing. They constitute first liens against all of the assets except those of Consolidated, which on petitioners' assumptions are about 20% of the assets of the combined enterprise. The bonds bear fixed interest rates of 6% and afford the bondholders the customary remedies in the event of default.

In exchange for their claims of \$3,640,000, the plan offers the bondholders new income bonds and preferred stock of an aggregate face amount of only \$3,015,000. Thus, even if the new securities be considered as worth their face amount, they are inadequate by \$625,000 to satisfy the bondholders' admitted claims. This is the precise amount of the accrued interest obligation, the effect of the plan being to cancel this obligation.

Not only do the bondholders lose their interest claim, but the new securities offered them are of a definitely inferior grade. The new bonds and preferred stock will bear interest and dividend rates, respectively, at the reduced rate of 5%, as compared with the 6% rate on the present bonds. The new bonds will be on an income basis with maturity extended for 20 years. The definition of default is extremely lenient and the remedies upon default are severely restricted (R. 39, 42-43). The preferred stock, of course, will have no maturity. It will be on a *noncumulative* income basis, except to the extent of available earnings, until all bonds are retired. This means, of course, that a distribution to common stockholders may be made in any year, after all charges on the preferred stock have been met for that year, even though dividends had not been earned and paid on the preferred stock in prior years.

As further emphasizing the obvious failure of these securities to constitute full compensation for the creditors' claims, even to the extent of their face amount, it should be noted that the securities issued to the bondholders do not carry with them control of the new company. Consolidated's preferred stockholders, who receive all of the new common stock initially to be issued, will retain control even though all the proposed warrants are exercised. Only in the event of a failure to pay certain minima of interest on the new bonds will control pass to the bondholders. (R. 49.)

The cumulative effect of the foregoing characteristics of the new securities compels the conclusion that they do not constitute full compensation to the bondholders even to the extent of their face amount. On the contrary, there is plainly no reasonable prospect that, upon termination of the reorganization or reasonably soon thereafter, these securities will be of a value equivalent to their face amount, and, consequently, they cannot be regarded as satisfying even *pro tanto* the bondholders' claims.

The warrants attached to the new preferred stock are not compensating factors of consequence. To make the bondholders whole merely for the cancellation of their accrued interest of \$625,000, the 60,280 shares of new common to which they would be entitled upon exercise of the warrants would have to attain a value exceeding the warrant price by \$625,000. This would require values ranging from \$12.40 per share (if the warrants were exercised within the first six months) to \$16.40 per share (if the warrants were exercised during the fifth year after issuance). On the other hand, petitioners' own estimates, which assume a maximum value of about \$1,300,000 for the equity in the new company after deducting the face amount of the new bonds and preferred stock, indicate a value per share of approximately \$4.50. It is plain, therefore, that the warrants represent no material measure of compensatory treatment for the bondholders.

In this connection it should be noted that Consolidated's common stockholders, who were found to have no equity whatsoever (R. 245), are given warrants to purchase the same class of stock as the bondholders, *and at a lower price*. Thus every exercise of a warrant by a bondholder would immediately enhance the book value of new common stock purchased by the old common stockholders, and conversely, every exercise of a warrant by the old common stockholders would dilute the book value of new common stock purchased by the old bondholders.¹¹

The foregoing discussion demonstrates the drastic reduction and impairment of the bondholders' claims contemplated by the plan and the resulting benefit to the Consolidated preferred stockholders. The bondholders receive nothing for their interest claims, and for their principal claims they receive inferior securities which are not full compensation

¹¹ The very issuance of warrants to the common stockholders makes the plan unfair as a matter of law, in the absence of circumstances making necessary the tender to them of a right to subscribe. *Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U. S. 445, 455-456; *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, 117, 121-122. The allotment of subscription warrants to a class of common stock for which there is no equity, in the absence of the necessary justification, violates the "fair and equitable" standard. Cf. *In re Utilities Power and Light Corp.*, 29 F. Supp. 763 (N. D. Ill.), appeal dismissed, C. C. A. 7th, March 9, 1940; *In re Chicago Great Western Railroad Co.*, 29 F. Supp. 149 (N. D. Ill.); see also *In re National Food Products Corporation*, 23 F. Supp. 979 (D. Md.).

therefor. It is not our position that under a reorganization plan bondholders cannot be given securities with characteristics inferior to those of the securities formerly held. Feasibility may so require, and the rule of full priority does not render a feasible reorganization impossible. But to the extent that the requirements of a financially sound reorganization make necessary the cutting down of bondholders' rights, adequate compensation must be given before junior classes may be permitted to participate. *Cf. Standard Gas and Electric Co. v. Deep Rock Oil Corp.* (C. C. A. 10th), decided January 13, 1941. Stated otherwise, the rule of full compensation cannot be satisfied merely by the issuance of securities in the appropriate face amount; but, if junior classes are to participate, the package of new securities which is offered to the bondholders must possess such protective provisions, security and rate of return as to make the securities of a value equal to the bondholders' claims.

B. THE TREATMENT ACCORDED TO THE BONDHOLDERS IS NOT FAIR
AND EQUITABLE

Petitioners attempt to justify the participation in the plan of Consolidated's preferred stockholders, despite the reduction and impairment of the rights of Union's and Consumers' bondholders, on the ground that Consolidated has assets worth \$859,000 which, they contend, are not subject to the

bondholders' claims.¹² The answer is twofold. In the first place, the record clearly establishes that Union and Consumers have valid and enforceable contractual claims against Consolidated which must be satisfied out of Consolidated's assets before its stockholders may participate at all. In the second place, in view of the intermingling of the properties of the three companies by Consolidated itself and the appropriation of the income thereof by Consolidated under the operating agreement, we believe that the whole enterprise must necessarily be regarded as a unit and that the claims of the bondholders must receive full priority out of all the assets owned by the enterprise before any interest therein is accorded the stockholders. When such right to full priority is recognized, it is clear that the plan is unfair to the bondholders.

1. The claims of Union and Consumers against Consolidated.—The books of Consolidated, as well as those of Union and Consumers, show an indebtedness of Consolidated to its subsidiaries of over \$5,000,000. The books of the subsidiaries show a

¹² Petitioners advanced the additional contention in the court below and in their petition for a writ of certiorari that the rule of full priority enunciated in *Case v. Los Angeles Lumber Co., Ltd.*, 308 U. S. 106, is not applicable to a solvent enterprise. This contention has now apparently been abandoned. For the reasons pointed out in the Memorandum for the Securities and Exchange Commission as Amicus Curiae, filed in connection with the petition for certiorari, the contention is plainly without merit.

total net claim of \$5,138,141.34, of which \$291,331.69 represents net current receivables, exclusive of depreciation, depletion, and amortization, and the remainder represents accumulated depreciation, depletion, and amortization (R. 317-319). Consolidated's own balance sheet shows a net liability to its subsidiaries of \$5,321,998.37, of which \$256,598.56 represents net current liabilities (R. 316).¹⁸ These records have been kept in accordance with the requirements of the original operating agreement (R. 236-237, 280-281, 299).

As we understand petitioners' argument, no contention is advanced that Consumers and Union do not have a valid claim against Consolidated to the extent, at least, of the net current liabilities, aggregating more than \$250,000, shown on Consolidated's books. Nor can there be any valid contention that Consolidated is not under *some* liability with respect to the depreciation, depletion, and amortization items. Even overlooking the serious doubts as to the validity of the modification agreement and treating that agreement as determining the rights of the parties, Consolidated is liable to its subsidiaries for depreciation, depletion, and amortization in amounts to be determined by retroactive appraisals made after termination of the operating agreement. The modification agreement expired

¹⁸ The variations in the figures shown by the books of Union and Consumers and of Consolidated may possibly be explained by the inclusion in the latter of accounts with other subsidiaries of Consolidated (R. 286-287, 316).

pursuant to its terms before the plan of reorganization in this case was confirmed. The record does not show that the one-year notice required for renewal (R. 180-181) was ever given. Thus it would have been entirely possible for the appraisal to have been made. Certainly Consolidated, which has been in possession of the subsidiaries' properties throughout the proceedings and controlled their directorates (R. 236), cannot advance the failure to have the appraisal made, and hence the extent of its liability determined, as justification for entirely negating liability.

Petitioners argue that there is no *present* claim by the subsidiaries against Consolidated, because under the modification no claim exists until the termination of the operating agreement. But the operating agreement, as modified, terminated on February 16, 1938. Although petitioners speak of a right of renewal (Brief, p. 28), the record does not show the exercise of the right, nor do petitioners assert that it was exercised.

Petitioners argue further that even after the claim is determined the subsidiaries cannot reach the assets of Consolidated, because Consolidated has the option to pay the claim in ten annual installments. But this option relates only to the amounts due for depreciation (R. 178-9), not to the \$250,000 or more due on current account. Moreover, the fact that payment of the remainder of the debt may be made in installments (which

bear interest) (R. 179) does not affect the provability of the debt under the broad definition of "claims" and "creditors" in Section 77B (b). Claims are there defined to include "debts, securities, other than stock, liens, or other interests of whatever character"; creditors are defined to include all holders of such claims "including claims under executory contracts, whether or not such claims would otherwise constitute provable claims under this Act." Compare Section 63 (a) (1), which permits proof of fixed liabilities "whether then payable or not," and Section 63 (a) (4), which permits proof of debts on open account, or on a contract express or implied, with no limitation as to maturity. The proof would be made by the trustees of the subsidiaries. Bankruptcy Act, Sections 57 (m), 77B (k).

Since liability does in fact exist, it is immaterial whether the amount due is around \$5,000,000, as the books show, or some lesser amount determined on the basis of an appraisal made under the modification agreement. In whatever amount liability exists, to that extent it subjects the assets of Consolidated to the prior claims of the bondholders. According to petitioners' valuation figures, the bondholders' claims held by the public exceed the value of the assets securing their liens by only \$300,000. To this may be added the \$200,000, principal and interest, of Union and Consumers bonds which Consolidated owns, and

which for present purposes we may assume constitutes a valid claim of Consolidated against Union and Consumers. It is therefore necessary to show liability only in the amount of \$500,000 from Consolidated to the subsidiaries in order to establish the bondholders' right to full compensation for the face amount of their claims. Of this \$500,000, at least \$250,000 is due on current accounts. Petitioners are therefore required to maintain that the liability for depreciation, depletion, and amortization, set out on the books of the companies at more than \$5,000,000, in fact amounts to no more than \$250,000. The record furnishes no support for any such proposition. To the contrary, as pointed out in respondent's brief (p. 19), even accepting the modification agreement as valid, depreciation, depletion, and amortization charges would be approximately \$1,250,000 on the basis of a \$3,300,000 valuation for Union's and Consumers' properties.

Petitioners seek to avoid the force of this position by contending that the provisions of the plan constitute a compromise of Consolidated's liability. The contention is completely without merit. It was first advanced upon the rehearing in the court below after the decision of this Court in the *Los Angeles Lumber* case; prior to that time, neither in the District Court nor in the Circuit Court of Appeals, did petitioners urge that participation in the plan by Consolidated's stockholders was to be

justified on the basis of a compromise. Upon the rehearing, the Circuit Court of Appeals expressly refused to treat the plan as embodying such a compromise, stating that no plan of reorganization for the companies could be held to be fair and equitable "until the claim is settled, either voluntarily or by litigation" (R. 374).

Certainly, if the plan was in fact intended as a compromise of liability, there is a complete failure of proof to that effect. A plan embodying a compromise should be presented to the court in such fashion as to indicate clearly the nature of the proposed compromise, the extent to which liability is recognized, and the allocation of securities based on the settlement. In the present case these standards have not been met; the alleged compromise has been presented to the court with its terms so obscured as not to afford to the court an opportunity to exercise the "informed, independent judgment" which the statute requires. *National Surety Co. v. Coriell*, 289 U. S. 426, 436; *Case v. Los Angeles Lumber Products Co., Ltd.*, *supra*, at 114-115.

But apart from these considerations, it is plain that any compromise in fact embodied in this plan of reorganization would have to be rejected on the merits. In the *Los Angeles Lumber* case, this Court recognized that although conflicting claims to specific assets might sometimes be settled, such settlement would be "in the discretion of the

court" (308 U. S. at 130). Approval of this plan on the basis of the asserted compromise would, we submit, be a gross abuse of discretion.

As pointed out above, on the basis of petitioners' own valuation figures, a liability of only \$500,000 on the part of Consolidated would have to be shown in order to establish the right of the bondholders to fully compensatory treatment for the face amount of their claims. Of this \$500,000, at least \$250,000 is due on current accounts. Consequently, in order to support the plan on the basis of an alleged compromise, petitioners must establish that Consolidated has such substantial defenses against the claims of the subsidiaries for depreciation, depletion, and amortization as to justify settlement of those claims, carried on Consolidated's own books at more than \$5,000,000, for less than \$250,000. In this respect, petitioners' case is entirely deficient; the defenses they assert for Consolidated are flimsy, if not captious.

The first of these alleged defenses is that, although Consolidated may be liable to Union and Consumers, it is not liable to their bondholders because of the provision in the operating agreement that that agreement was not made for the benefit of any third person. But the question at this point is not whether the bondholders may directly enforce the liability against Consolidated; the question is only whether and to what extent that liability exists. To the extent that it does exist, the claims of Union and Consumers against

Consolidated are valuable assets of the subsidiaries which are subject to the claims of the bondholders. The normal procedure for adjudication of the existence and amount of Consolidated's liability would be for trustees of the subsidiaries to file claims against Consolidated's estate and for the bankruptcy court to decide the validity and amount of those claims. Section 57 (m); Section 77B (k). Cf. *Pepper v. Litton*, 308 U. S. 295. Contrary to petitioners' contention (Br. 29), there would be no necessity for foreclosure of the trust indentures under the law of California. The effect of the enforcement of the claim under the operating agreement would be to draw the assets of Consolidated into the subsidiaries' estates. The bondholders could then either have their security valued under section 57 (h) of the Bankruptcy Act (see sec. 77B (b)) and prove a general claim for the deficiency, or they could prove their entire claims as general claims, waiving their security. *Gilbert's Collier on Bankruptcy* (4th ed., 1937) sec. 1043. In either case, since the bondholders are the only significant creditors of Union and Consumers (R. 248, 317-319), their claims would have to be satisfied in full out of any assets in the estates before Consolidated, as stockholder of the subsidiaries, could share.

The other alleged justification for the compromise is that without the compromise the bondholders would be faced with extensive procedural obstacles before they could realize upon the claims.

If this means that the compromise avoids foreclosure and sale, the answer is, as we have stated, that no foreclosure is necessary. If it means that the compromise avoids obstructive litigation, the answer is that a compromise for this purpose alone is not justified. In the *Los Angeles Lumber* case, this Court stated (pp. 129-130):

The conclusion of the District Court that avoidance of litigation with the stockholders gave validity to their claim for recognition in the plan involves a misconception of the duties and responsibilities of the court in these proceedings. Whatever might be the strategic or nuisance value of such parties outside of § 77B is irrelevant to the duties of the court in confirming or disapproving a plan under that section. In these proceedings there is no occasion for the court to yield to such pressures. If the priorities of creditors which the law protects are not to be diluted, it is the clear duty of the court to resist all such assertions.

We believe it is evident, therefore, that the asserted compromise is no justification for the participation in the plan by Consolidated's preferred stockholders, that sufficient (if not all) of Consolidated's assets are subject to the claims of Union and Consumers to provide fully compensatory treatment for the bondholders, and that consequently the failure of the plan to accord them such treatment renders the plan unfair and inequitable as a matter of law.

2. *The intermingling of the assets by Consolidated*—The assets allegedly belonging to Consolidated are subject to the claims of the bondholders even apart from the contractual liability of Consolidated to Union and Consumers.

Under the operating agreement, Consolidated completely dominated the subsidiaries. It took possession of their properties and operated them in connection with its own as though all the properties were consolidated under a single ownership, and it commingled the assets of each so that separate identification thereof has become impossible. This commingling alone should throw upon Consolidated the burden of identifying its own assets in order to assert a claim to any. *Union Naval Stores Co. v. United States*, 240 U. S. 284, 291; *The Idaho*, 93 U. S. 575; *Intermingled Cotton Cases*, 92 U. S. 65; *The Distilled Spirits*, 11 Wall. 356. But Consolidated exerted its control over the subsidiaries to do more than commingle the assets. On the one hand, it took possession of the subsidiaries' properties through the operating agreement and appropriated for itself all revenues from operations (R. 170-171), thus disabling the subsidiaries from performing the covenants of their indenture agreements, including particularly the interest, sinking fund and depreciation and depletion provisions. On the other hand, it violated its own covenant to supply the subsidiaries with the necessary funds to meet interest and sinking fund require-

ments (R. 167-168). In all respects, except for some bookkeeping purposes and the failure expressly to assume the subsidiaries' mortgage debts, it treated the enterprise as a unit and the subsidiaries' properties as its own.

Under these circumstances, we believe that the bankruptcy court, as a court of equity, is not required to pay regard to the separate corporate entities of the subsidiaries, which Consolidated itself has so consistently disregarded. Rather, it is called upon to treat the enterprise as though the properties of the different companies were actually held under single ownership by a corporation liable for all the debts. Compare *Davis v. Alexander*, 269 U. S. 114; *Baltimore & Ohio Tel. Co. v. Interstate Tel. Co.*, 54 Fed. 50 (C. C. A. 4th); *Pennsylvania Canal Co. v. Brown*, 235 Fed. 569 (C. C. A. 3d), certiorari denied, 242 U. S. 646; *The Willem Van Driel, Sr.*, 252 Fed. 35 (C. C. A. 4th), certiorari denied, 248 U. S. 566; *Trustees System Co. v. Payne*, 65 F. (2d) 103 (C. C. A. 3d); *Central Republic Bank & Tr. Co. v. Caldwell*, 58 F. (2d) 721 (C. C. A. 8th).

So considered, of course, all the assets of the enterprise would be subject to the full amount of the bondholders' claims and the stockholders would be entitled to participate only to the extent of any remaining balance after fully compensatory provision is made for such claims. As we have shown, the plan fails to accord such full compensation to the bondholders.

Philadelphia Company v. Dipple, Nos. 242, 243, present Term, decided February 3, 1941, is not opposed to our contention. Although in that case this Court refused to disregard the corporate entities of various companies which had been operated as a unit, the relationship of the operating company to the underlying companies was there merely a creditor-debtor relationship under a lease; and not, as here, the relationship of parent and subsidiary. Moreover, as the Court pointed out, to ignore the separate corporate entities in the *Dipple* case might have affected the claims of other creditors adversely. No such consideration is involved in the present case.

No serious consideration need be given petitioners' contention (Br. pp. 30-31) that even if Consolidated's assets are subject to the debts, the plan is fair. As we have shown, the bondholders are not fully compensated for their prior claims, and no plan can be fair which does not provide full compensation. The assertion that the preferred stockholders are "contributing" 22% of the assets, ignores the fact that the assets must be applied to full compensation for the bondholders before the preferred stockholders can "contribute" the residue, and that in "accepting" a junior position the preferred stockholders give up nothing to which they are entitled. Moreover, petitioners' assertion rests on assumptions as to the value of the physical assets and the good will which we believe to be unsupported by satisfactory evidence (*supra*, pp. 26-28). Finally, we think it too clear for discus-

sion that a plan which gives the preferred stockholders "the right to elect only 5 out of 9 directors" (Pet. Br., p. 31) in return for their alleged 22% "contribution" unduly favors them and discriminates against the bondholders.

IV

A PLAN OF REORGANIZATION IS NOT UNFAIR AND IN-EQUITABLE AS A MATTER OF LAW BECAUSE CLASSES OF LIENHOLDERS ARE NOT GIVEN FULLY COMPENSATORY TREATMENT OUT OF THE PARTICULAR ASSETS SUBJECT TO THEIR RESPECTIVE LIENS, IF THEY ARE OTHERWISE GIVEN FULLY COMPENSATORY TREATMENT

The court below appears to have assumed that it was bound by the *Los Angeles Lumber* decision to hold that the plan of reorganization is unfair because it permits Union's bondholders to share in Consumer's assets and Consumer's bondholders to share in Union's assets. In other words, the court below apparently held that a class of claimants with a lien on particular properties must receive fully compensatory treatment out of those properties and may not as a matter of law receive less than fully compensatory treatment out of those properties even though it is adequately compensated with an interest in other properties. Such a ruling would make impossible the formulation and consummation of a plan of reorganization which provides for unified operation of all the properties by a new corporation and for the satisfaction of the claims of the bondholders through their participa-

tion in securities covering all of the properties of the new corporation. The proposal of such a plan here resulted largely from the manner in which the enterprise had been operated in the past and the conclusion of the parties, accepted by the Special Master and the District Court, that it was desirable that the separate liens be displaced and that the properties be operated as a unit in the future (R. 147-148, 261, 271). The Circuit Court of Appeals did not question this assumption.

We believe it plain that the *Los Angeles Lumber* decision does not require that a plan be held unfair and inequitable, as a matter of law, where bondholders receive less than full compensation out of the assets on which they have a lien, provided that they are adequately compensated for the loss of their prior claims by interests in other assets. The respondent has not questioned this. He expressly disclaims any contention to the contrary in his brief (p. 26).

Obviously, lienors may have to surrender their priority to, or share it with, persons who contribute new funds to the enterprise; in such case their compensation will consist in the acquisition by their corporation of the new funds. The present situation is similar, except that the contribution made by each group of lienholders for the right to share in the assets contributed by the other group is made in property rather than in money. Consumers' bondholders share their priority with per-

sons who contribute property necessary for the success of the enterprise as a whole, namely, the Union bondholders; the obverse is likewise true. So long as each group shares on an equitable basis in the securities of the combined enterprise, the plan of reorganization satisfies the requirements of the *Los Angeles Lumber* rule.¹⁴

Furthermore, to read into the rule of the *Los Angeles Lumber* case a requirement that fully compensatory treatment for liens must be given out of the assets subject to the liens would have disastrous practical consequences. The elimination of divisional liens in the reorganization of corporations is frequently necessary and desirable. The problem arises in many industrial and railroad reor-

¹⁴ Because of the inadequacy of the record, we do not now express an opinion as to whether the plan of reorganization is fair in its treatment of the two groups of bondholders with respect to each other. We do, however, disagree with the suggestion of petitioners in No. 444 (Br., p. 18) and of petitioners in No. 400 (Br., p. 18) that no more precise findings of value than those which have been made are necessary in order to reach a conclusion as to the fairness of the treatment of the bondholders *inter se*. The statement of petitioners in No. 444 (Br., p. 11) that new bonds of one issue equal in amount to the aggregate of the two old issues, and secured by both properties, would be reasonably compensatory expressly assumes that the ratios of the values of the respective properties to the debts which they respectively secure are the same. The accuracy of this assumption cannot be determined without more precise conclusions as to the values of the respective properties.

ganizations where it is necessary or desirable to maintain unified operation of properties mortgaged to secure separate bond issues and where a simplified capital structure is required. The problem may also arise, even in the absence of liens, with respect to the treatment of the securities of any two or more corporations the properties of which should be combined in a single reorganized corporation.

Reorganization in some types of cases might be impossible under the holding of the court below. The reorganization provisions of the Bankruptcy Act,¹⁵ and comparable provisions of other statutes,¹⁶ require that a plan of reorganization be feasible as well as fair and equitable. If the holding of the court below is correct, a plan of reorganization

¹⁵ Sec. 77 (e), 11 U. S. C. § 205 (e); Sec. 77 B (f), 11 U. S. C. § 207 (f); Chapter X, Secs. 174 and 221 (2), 11 U. S. C. §§ 574 and 621 (2); Chapter XI, Sec. 366 (3), 11 U. S. C. § 766 (d); Chapter XII, Sec. 472 (3), 11 U. S. C. § 872 (3); Chapter XIII, Sec. 656 (3), 11 U. S. C. § 1056 (3).

¹⁶ Sections 11 (d) and 11 (e) of the Public Utility Holding Company Act of 1935, 15 U. S. C. § 79k (d) and (e), authorize the Securities and Exchange Commission to approve, and to take steps to enforce, plans of reorganization of registered public-utility holding companies or their subsidiaries which must be both "fair and equitable" and "necessary to effectuate the provisions of subsection (b)." Among other things, Sec. 11 (b) requires the Commission to direct each registered holding company and subsidiary thereof to take steps to insure that its corporate structure is not unduly or unnecessarily complicated.

which fails to preserve priorities of separate lienors against the properties securing their respective claims cannot be fair. Yet in many cases any plan attempting to preserve separate liens would necessitate so complicated a capital structure that it would not be feasible. Consequently, in some cases, no plan of reorganization complying with the statutory standards would be possible. We submit that the *Los Angeles* case compels no such result.

The decision below in this regard is opposed in principle to a number of decisions of the lower federal courts and of the Interstate Commerce Commission in comparable reorganization cases. These authorities are collected in the brief filed on behalf of the petitioners in No. 444 (pp. 11-13) and consequently will not be further discussed in this brief.

CONCLUSION

We submit that the decision of the court below reversing the order confirming the plan of reorganization should be affirmed, but that the mandate of this Court should issue in such form that the District Court may, upon proper findings of the necessity or desirability of unification, approve a plan of reorganization providing for unified operation of the enterprise by a single reorganized corporation, without any requirement that the full compensation which each class of security holders is to be accorded for the value of its interests be given

out of the particular assets subject to its claims.

Respectfully submitted,

FRANCIS BIDDLE,
Solicitor General.

RICHARD H. DEMUTH,
Special Assistant to the Attorney General.

CHESTER T. LANE,
General Counsel,
Securities and Exchange Commission.

MARTIN RIGER,
GEORGE ROSIER,
HOMER Kripke,
IRVING S. ROGERS,
Attorneys,
Securities and Exchange Commission.

APPENDIX

The applicable provisions of the Bankruptcy Act, as they existed prior to the 1938 amendments (11 U. S. C. Supp. V, § 1 *et seq.*), are as follows:

Sec. 57 (h) (11 U. S. C. § 93 (h)):

The value of securities held by secured creditors shall be determined by converting the same into money according to the terms of the agreement pursuant to which such securities were delivered to such creditors or by such creditors and the trustee, by agreement, arbitration, compromise, or litigation, as the court may direct, and the amount of such value shall be credited upon such claims, and a dividend shall be paid only on the unpaid balance.

Sec. 57 (m) (11 U. S. C. § 93 (m)):

The claim of any estate which is being administered in bankruptcy against any like estate may be proved by the trustee and allowed by the court in the same manner and upon like terms as the claims of other creditors.

Sec. 63 (a) (11 U. S. C. § 103 (a)):

Debts of the bankrupt may be proved and allowed against his estate which are (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not, with any interest thereon which would have been recoverable at that date or with a rebate

of interest upon such as were not then payable and did not bear interest; * * * (4) founded upon an open account, or upon a contract express or implied; * * *

Sec. 77B (b) (11 U. S. C. § 207 (b)):

* * * The term "creditors" shall include for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims of whatever character against the debtor or its property, including claims under executory contracts, whether or not such claims would otherwise constitute provable claims under this Act. The term "claims" includes debts, securities, other than stock, liens, or other interests of whatever character. * * * In the case of secured claims entitled to the provisions of clause (5) of this subdivision (b), the value of the security shall be determined in the manner provided in section 57, clause (h) of this Act, and if the amount of such value shall be less than the amount of the claim, the excess may be classified as an unsecured claim. * * *

Sec. 77B (f) (11 U. S. C. § 207 (f)):

After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible * * *

Sec. 77B (k) (11 U. S. C. § 207 (k)):

If an order is entered directing the trustee or trustees to liquidate the estate pursuant to the provisions of clause (8) of subdivision (c) of this section: (1) The case may be referred to a referee as provided in section

22, who shall be compensated as provided in section 40; (2) the first meeting of creditors shall be held as provided in section 55, upon notice as provided in section 58; (3) a trustee or trustees shall be appointed as provided in section 44, and be compensated as provided in section 48; (4) claims which are provable under section 63 may be proved as provided in section 57, except that the time within which proof may be made shall not expire until six months after the date of the last publication of the notice of the first meeting; (5) debts shall be entitled to priority as provided in section 64; (6) sales shall be made as provided in subdivision (b) of section 70; (7) dividends may be declared and paid as provided in section 65. None of the sections enumerated in this subdivision (k), except subdivision (g), (i), (j), and (m) of section 57, and subdivisions (a) and (e) of section 70, shall apply to proceedings instituted under this section 77B unless and until an order has been entered directing the trustee or trustees to liquidate the estate. All other provisions of this Act, except such as are inconsistent with the provisions of this section 77B, shall apply to proceedings instituted under this section, whether or not an order to liquidate the estate has been entered. For the purposes of such application, provisions relating to "bankrupts" shall be deemed to relate also to "debtors"; "bankruptcy proceedings" or "proceedings in bankruptcy" shall be deemed to include proceedings under this section; the date of the order approving the petition or answer under this section shall be taken to be the date of adjudication, and such order shall have the same consequences and effect as an order of adjudication.

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SUPREME COURT OF THE UNITED STATES.

Nos. 400 and 444.—OCTOBER TERM, 1940.

Consolidated Rock Products Co., et al.,

Petitioners,

400

vs.

E. Blois du Bois.

On Writs of Certiorari to
the United States Circuit
Court of Appeals for the
Ninth Circuit.

F. D. Badgley, et al., Petitioners,

444

vs.

E. Blois du Bois.

[March 3, 1941.]

Mr. Justice DOUGLAS delivered the opinion of the Court.

This case involves questions as to the fairness under § 77B of the Bankruptcy Act (48 Stat. 912) of a plan of reorganization for a parent corporation (Consolidated Rock Products Co.) and its two wholly owned subsidiaries¹—Union Rock Co. and Consumers Rock and Gravel Co., Inc. The District Court confirmed the plan; the Circuit Court of Appeals reversed. 114 F. (2d) 102. We granted the petitions² for certiorari because of the importance in the administration of the reorganization provisions of the Act of certain principles enunciated by the Circuit Court of Appeals.

The stock of Union and Consumers is held by Consolidated. Union has outstanding in the hands of the public³ \$1,877,000 of 6% bonds secured by an indenture on its property, with accrued and unpaid interest⁴ thereon of \$403,555—a total mortgage indebt-

¹ The proceedings under § 77B were instituted in 1935 by the filing of separate voluntary petitions by Consolidated, Union and Consumers. No trustees have been appointed, Consolidated remaining in possession.

² The petition in No. 400 raises all of the questions discussed herein, while the petition in No. 444 raises only the question as to the authority of the reorganization court to approve a plan which substitutes one mortgage covering all of the property for so-called divisional mortgages on separate units of that property. The Interstate Commerce Commission and the Securities and Exchange Commission filed memoranda urging that the petition in No. 444 be granted and that the petition in No. 400 be granted to the extent that it raised the same question as that presented by the petition in No. 444.

³ \$102,500 face amount of Union's bonds are held by Consolidated.

⁴ As of April 1, 1937, the effective date of the plan. Interest on Union bonds has been in default since March 1, 1934.

edness of \$2,280,555. Consumers has outstanding in the hands of the public⁵ \$1,137,000 of 6% bonds secured by an indenture on its property, with accrued and unpaid interest⁶ thereon of \$221,715—a total mortgage indebtedness of \$1,358,715. Consolidated has outstanding 285,947 shares of no par value preferred stock⁷ and 397,455 shares of no par common stock.

The plan of reorganization calls for the formation of a new corporation to which will be transferred all of the assets of Consolidated, Union,⁸ and Consumers free of all claims.⁹ The securities of the new corporation are to be distributed as follows:

Union and Consumers bonds held by the public will be exchanged for income bonds¹⁰ and preferred stock¹¹ of the new company. For 50 per cent of the principal amounts of their claims, those bondholders will receive income bonds secured by a mortgage on all of the property of the new company; for the balance they will receive an equal amount of par value preferred stock. Their claims to accrued interest are to be extinguished, no new securities being issued therefor. Thus Union bondholders for their claims of \$2,280,555 will receive income bonds and preferred stock in the face amount of \$1,877,000; Consumers bondholders for their claims of \$1,358,715 will receive income bonds and preferred stock¹²

⁵ \$63,500 face amount of Consumer's bonds are held by Consolidated.

⁶ Interest has been in default since July 1, 1934.

⁷ With a preference on liquidation of \$25 per share plus accrued dividends.

⁸ Reliance Rock Co. is a wholly owned subsidiary of Union whose properties also were to be transferred to the new company.

⁹ The claims of general creditors will be paid in full or assumed by the new company.

¹⁰ These bonds will mature in 20 years and will bear interest at the rate of 5 per cent if earned. The interest will be cumulative if not paid. The bonds, as well as the preferred stock, to be issued to Union and Consumers bondholders will be in separate series. The net income of the new company is to be divided into two equal parts: each part to be used to pay, with respect to bonds and preferred stock of each series, first, interest and sinking fund payments on the bonds; second, dividends and sinking fund payments on the preferred stock. Income remaining will be available for general corporate purposes.

¹¹ The new preferred stock will have a par value of \$50 and will carry a dividend of 5 per cent. It will be noncumulative until the retirement of the bonds of the same series except to the extent that net income is available for dividends. Thereafter it will be cumulative.

¹² All of the new income bonds and preferred stock are to be issued to the public holders of Union and Consumers bonds.

in the face amount of \$1,137,000. Each share of new preferred stock will have a warrant for the purchase of two shares of new \$2 par value common stock at prices ranging from \$2 per share within six months of issuance, to \$6 per share during the fifth year after issuance.

Preferred stockholders of Consolidated will receive one share of new common stock (\$2 par value) for each share of old preferred or an aggregate of 285,947 shares of new common.

A warrant to purchase one share of new common for \$1 within three months of issuance will be given to the common stockholders of Consolidated for each five shares of old common.¹³

The new preferred stock, to be received by the old bondholders, will elect four out of nine directors of the new company; the new common stock will elect the remainder.¹⁴ But on designated delinquencies in payment of interest on the new bonds, the old bondholders would be entitled to elect six of the nine directors.

The bonds of Union and Consumers held by Consolidated,¹⁵ the stock of those companies held by Consolidated, and the inter-company claims (discussed hereafter) will be cancelled.

In 1929 when Consolidated acquired control of these various properties, they were appraised in excess of \$16,000,000 and it was estimated that their annual net earnings would be \$500,000. In 1931 they were appraised by officers at about \$4,400,000, "exclusive of going concern, good will and current assets." The District Court did not find specific values for the separate properties of Consolidated, Union, or Consumers, or for the properties of the enterprise as a unit. The average of the valuations (apparently based on physical factors) given by three witnesses¹⁶ at the hearing before the master were \$2,202,733 for Union as against a mortgage indebtedness of \$2,280,555; \$1,151,033 for Consumers as against a mortgage indebtedness of \$1,358,715. Relying on similar testimony, Consolidated argues that the value of its property, to

¹³ 79,491 shares of new common will be reserved for the exercise of warrants issued to old common stockholders; an additional 60,280 shares of new common, for the exercise of warrants attached to the new preferred.

¹⁴ It is apparent that the majority of the new common will be held by the old preferred stockholders even if all warrants are exercised.

¹⁵ See notes 3 and 5, *supra*.

¹⁶ Two officers and one ex-employee. These valuation figures included the properties of Reliance. See note 8, *supra*.

be contributed to the new company, is over \$1,359,000, or exclusive of an alleged good will of \$500,000, \$859,784. These estimated values somewhat conflict with the consolidated balance sheet (as at June 30, 1938) which shows assets of \$3,723,738.15 and liabilities (exclusive of capital and surplus) of \$4,253,224.41. More important, the earnings record of the enterprise casts grave doubts on the soundness of the estimated values. No dividends were ever paid on Consolidated's common stock; and except for five quarterly dividends in 1929 and 1931, none on its preferred stock. For the eight and a half years from April 1, 1929, to September 30, 1937, Consolidated had a loss of about \$1,200,000 before bond interest but after depreciation and depletion. And except for the year 1929, Consolidated had no net operating profit, after bond interest and amortization, depreciation and depletion, in any year down to September 30, 1937.¹⁷ Yet on this record the District Court found that the present fair value of all the assets of the several companies, exclusive of good will and going concern value, was in excess of the total bonded indebtedness, plus accrued and unpaid interest. And it also found that such value, including good will and going concern value, was insufficient to pay the bonded indebtedness plus accrued and unpaid interest and the liquidation preferences and accrued dividends on Consolidated preferred stock. It further found that the present fair value of the assets admittedly subject to the trust indentures of Union and Consumers was insufficient to pay the face amount, plus accrued and unpaid interest of the respective bond issues. In spite of that finding, the District Court also found that "it would be physically impossible to determine and segregate with any degree of accuracy or fairness properties which originally belonged to the companies separately"; that as a result of unified operation properties of every character "have been commingled and are now in the main held by Consolidated without any way of ascertaining what part, if any thereof, belongs to each or any of the companies separately"; and that, as a consequence, an appraisal "would be of such an indefinite and unsatisfactory nature as to produce further confusion."

The unified operation which resulted in that commingling of assets was pursuant to an operating agreement which Consolidated

¹⁷ The hearings on the plan were held before a master during November, 1937.

caused its wholly owned subsidiaries¹⁸ to execute in 1929. Under that agreement the subsidiaries ceased all operating functions and the entire management, operation and financing of the business and properties of the subsidiaries were undertaken by Consolidated. The corporate existence of the subsidiaries, however, was maintained and certain separate accounts were kept. Under this agreement Consolidated undertook, *inter alia*, to pay the subsidiaries the amounts necessary for the interest and sinking fund provisions of the indentures and to credit their current accounts with items of depreciation, depletion, amortization and obsolescence.¹⁹ Upon termination of the agreement the properties were to be returned and a final settlement of accounts made, Consolidated meanwhile to retain all net revenues after its obligations thereunder to the subsidiaries had been met. It was specifically provided that the agreement was made for the benefit of the parties, not "for the benefit of any third person." Consolidated's books as at June 30, 1938, showed a net indebtedness under that agreement to Union and Consumers of somewhat over \$5,000,000. That claim was cancelled by the plan of reorganization, no securities being issued to the creditors of the subsidiaries therefor. The District Court made no findings as respects the amount or validity of that intercompany claim; it summarily disposed of it by concluding that any liability under the operating agreement was "not made for the benefit of any third parties and the bondholders are included in that category."

We agree with the Circuit Court of Appeals that it was error to confirm this plan of reorganization.

I. On this record no determination of the fairness of any plan of reorganization could be made. Absent the requisite valuation data, the court was in no position to exercise the "informed, inde-

¹⁸ This agreement covered the properties of Reliance as well as Union and Consumers. By a modification made in 1933 the agreement was to expire in February, 1938, Consolidated having an option to extend the agreement for another five years on specified notice.

¹⁹ The agreement was modified in 1933 (by two officers acting for each of the four companies) whereby the depreciation to be credited to the subsidiaries should be credited only on termination of the agreement. At that time Consolidated was to have the right by paying a five per cent penalty, to pay twenty-five per cent of the amount of the depreciation credit in ten annual installments and the balance at the end of ten years from the date of termination. Some question has been raised as to the propriety of that modification, a question on which we express no opinion.

pendent judgment" (*National Surety Co. v. Coriell*, 289 U. S. 426, 436) which appraisal of the fairness of a plan of reorganization entails. *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106. And see *First National Bank v. Flershem*, 290 U. S. 504, 525. There are two aspects of that valuation problem.

In the first place, there must be a determination of what assets are subject to the payment of the respective claims. This obvious requirement was not met. The status of the Union and Consumers bondholders emphasizes its necessity and importance. According to the District Court the mortgaged assets are insufficient to pay the mortgage debt. There is no finding, however, as to the extent of the deficiency or the amount of unmortgaged assets and their value. It is plain that the bondholders would have, as against Consolidated and its stockholders, prior recourse against any unmortgaged assets of Union and Consumers. The full and absolute priority rule of *Northern Pacific Railway Co. v. Boyd*, 228 U. S. 482, and *Case v. Los Angeles Lumber Products Co.*, *supra*, would preclude participation by the equity interests in any of those assets until the bondholders had been made whole. Here there are some unmortgaged assets, for there is a claim of Union and Consumers against Consolidated—a claim which according to the books of Consolidated is over \$5,000,000 in amount. If that claim is valid,²⁰ or even if it were allowed only to the extent of 25% of its face amount,²¹ then the entire assets of Consolidated would be drawn down into the estates of the subsidiaries. In that event Union and Consumers might or might not be solvent in the bankruptcy sense. But certainly it would render untenable the present contention of Consolidated and the preferred stockholders that they are contributing all of the assets of Consolidated to the new company in exchange for which they are entitled to new securities. On that theory of the case they would be making a contribution of only such assets of Consolidated, if any, as remained after any deficiency of the bondholders had been wholly satisfied.

²⁰ Consolidated seems to admit that that claim is valid, at least to the extent of net current liabilities aggregating more than \$250,000 as of June 30, 1938.

²¹ Respondent points out that even on the basis of a \$3,300,000 valuation of the properties of Union and Consumers depreciation, depletion and obsolescence charges would be approximately \$1,250,000.

There are no barriers to a valuation and enforcement of that claim. If as Consolidated maintains the subsidiaries have no present claim against it,²² the claim can readily be discounted to present worth. It is provable by trustees of the subsidiaries, for the term "creditors" under § 77B(b) includes "holders of claims of whatever character against the debtor or its property, including claims under executory contracts; whether or not such claims would otherwise constitute provable claims under this Act."²³ Consolidated makes some point of the difficulty and expense of determining the extent of its liability under the operating agreement and of the necessity to abide by the technical terms of that agreement²⁴ in ascertaining that liability. But equity will not permit a holding company, which has dominated and controlled its subsidiaries, to escape or reduce its liability to those subsidiaries by reliance upon self-serving contracts which it has imposed on them. A holding company, as well as others in dominating or controlling positions (*Pepper v. Litton*, 308 U. S. 295), has fiduciary duties to security holders of its system which will be strictly enforced. See *Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307. In this connection Consolidated cannot defeat or postpone the accounting because of the clause in the operating agreement that it was not made for the benefit of any third person. The question here is not a technical one as to who may sue to enforce that liability. It is merely a question as to the amount by which Consolidated is indebted to the subsidiaries and the proof and allowance of that claim. The subsidiaries need not be sent into state courts to have that liability determined. The bankruptcy court having exclusive jurisdiction over the holding company and the subsidiaries has plenary power to adjudicate all the issues pertaining to

²² Consolidated maintains that there is no present claim against it because no claim exists until termination of the operating agreement which ran until February 1938, with an option in Consolidated to extend it for five years. But it does not assert, nor does the record show, that the option was exercised. But even if it had been, only the time when the amounts accrued were payable would be affected.

²³ For an equally broad definition of "creditor" under Ch. X of the Chandler Act (52 Stat. 840) see § 106(1) and (4).

²⁴ Thus Consolidated argues that under the operating agreement the machinery for an appraisal provided therein must be employed. Yet assuming *ergo quod* that that is true, Consolidated which has been in possession and control throughout cannot rely on the failure to have an appraisal as a reason for blocking or delaying its duty to account.

the claim. The intimations of Consolidated that there must be foreclosure proceedings and protracted litigation in state courts involve a misconception of the duties and powers of the bankruptcy court. The fact that Consolidated might have a strategic or nuisance value outside of § 77B does not detract from or impair the power and duty of the bankruptcy court to require a full accounting as a condition precedent to approval of any plan of reorganization. The fact that the claim might be settled, with the approval of the Court after full disclosure and notice to interested parties, does not justify the concealed compromise effected here through the simple expedient of extinguishing the claim.

So far as the ability of the bondholders of Union and Consumers to reach the assets of Consolidated on claims of the kind covered by the operation agreement is concerned, there is another and more direct route which reaches the same end. There has been a unified operation of those several properties by Consolidated pursuant to the operating agreement. That operation not only resulted in extensive commingling of assets. All management functions of the several companies were assumed by Consolidated. The subsidiaries abdicated. Consolidated operated them as mere departments of its own business. Not even the formalities of separate corporate organizations were observed, except in minor particulars such as the maintenance of certain separate accounts. In view of these facts, Consolidated is in no position to claim that its assets are insulated from such claims of creditors of the subsidiaries. To the contrary, it is well settled that where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management. *Davis v. Alexander*, 269 U. S. 114, 117; *Joseph R. Ford Co. v. State of Maryland*, 219 Fed. 827, 829; *Stark Electric R. Co. v. M'Ginty Contracting Co.*, 238 Fed. 657, 661-663; *The Willem Van Driel, Sr.*, 252 Fed. 35, 37-39; *Luckenbach S.S. Co. v. W. R. Grace & Co.*, 267 Fed. 676, 681; *Costan v. Manila Electric Co.*, 24 F. (2d) 383; *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F. (2d) 265, 267; *Dillard & Coffin Co. v. Richmond Cotton Oil Co.*, 140 Tenn. 290. We are not dealing here with a situation where other creditors of a parent company are competing with creditors of its subsidiaries. If me-

ticulous regard to corporate forms, which Consolidated has long ignored, is now observed, the stockholders of Consolidated may be the direct beneficiaries. Equity will not countenance such a result. A holding company which assumes to treat the properties of its subsidiaries as its own cannot take the benefits of direct management without the burdens.

We have already noted that no adequate finding was made as to the value of the assets of Consolidated. In view of what we have said, it is apparent that a determination of that value must be made so that criteria will be available to determine an appropriate allocation of new securities between bondholders and stockholders in case there is an equity remaining after the bondholders have been made whole.

There is another reason why the failure to ascertain what assets are subject to the payment of the Union and Consumers bonds is fatal. There is a question raised as to the fairness of the plan as respects the bondholders *inter se*. While the total mortgage debt of Consumers is less than that of Union, the net income of the new company, as we have seen,²⁵ is to be divided into two equal parts, one to service the new securities issued to Consumers bondholders, the other to service those issued to Union bondholders. That allocation is attacked here by respondent as discriminatory against Union, on the ground that the assets of Union are much greater in volume and in value than those of Consumers. It does not appear from this record that Union and Consumers have individual earnings records. If they do not, some appropriate formula for at least an approximate ascertainment of their respective assets must be designed in spite of the difficulties occasioned by the commingling. Otherwise the issue of fairness of any plan of reorganization as between Union and Consumers bondholders cannot be intelligently resolved.

In the second place, there is the question of the method of valuation. From this record it is apparent that little, if any, effort was made to value the whole enterprise by a capitalization of prospective earnings. The necessity for such an inquiry is emphasized by the poor earnings record of this enterprise in the past. Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of re-

²⁵ *Supra*, note 10.

organization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a *sine qua non* to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule of *Case v. Los Angeles Lumber Products Co., supra*. Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result.

As Mr. Justice Holmes said in *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas*, 210 U. S. 217, 226, "the commercial value of property consists in the expectation of income from it." And see *Cleveland, Cincinnati, Chicago & St. Louis Ry. Co. v. Backus*, 154 U. S. 439, 445. Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity. *Temmer v. Denver Tramway Co.*, 18 F. (2d) 226, 229; *New York Trust Co. v. Continental & Commercial Trust & Sav. Bank*, 26 F. (2d) 872, 874. The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable. *In re Wickwire Spencer Steel Co.*, 12 F. Supp. 528, 533; 2 Bonbright, *Valuation of Property*, pp. 870-881, 884-893. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. A sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate. See Finletter, *The Law of Bankruptcy Reorganization*, pp. 557 *et seq.* But hardly more than that was done here. The Circuit Court of Appeals correctly left the matter of a formal appraisal to the

discretion of the District Court. The extent and method of inquiry necessary for a valuation based on earning capacity are necessarily dependent on the facts of each case.

II. The Circuit Court of Appeals held that the absolute priority rule of *Northern Pacific Railway Co. v. Boyd*, *supra*, and *Case v. Los Angeles Lumber Products Co.*, *supra*, applied to reorganizations of solvent as well as insolvent companies. That is true. Whether a company is solvent or insolvent in either the equity or the bankruptcy sense, "any arrangement of the parties by which the subordinated rights and interests of the stockholders are attempted to be secured at the expense of the prior rights" of creditors "comes within judicial denunciation". *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co.*, 174 U. S. 674, 684. And we indicated in *Case v. Los Angeles Lumber Products Co.*, *supra*, that that rule was not satisfied even though the "relative priorities" of creditors and stockholders were maintained (pp. 119-120).

The instant plan runs afoul of that principle. In the first place, no provision is made for the accrued interest on the bonds. This interest is entitled to the same priority as the principal. See *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U. S. 261, 266-267; *Ticonic National Bank v. Sprague*, 303 U. S. 406. In the second place, and apart from the cancellation of interest, the plan does not satisfy the fixed principle of the *Boyd* case even on the assumption that the enterprise as a whole is solvent in the bankruptcy sense. The bondholders for the principal amount of their 6% bonds receive an equal face amount of new 5% income bonds and preferred stock, while the preferred stockholders receive new common stock. True, the relative priorities are maintained. But the bondholders have not been made whole. They have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of preferred stock, and their former strategic position has been weakened. Those lost rights are of value. Full compensatory provision must be made for the entire bundle of rights which the creditors surrender.

The absolute priority rule does not mean that bondholders cannot be given inferior grades of securities, or even securities of the same

grade as are received by junior interests. Requirements of feasibility²⁶ of reorganization plans frequently necessitate it in the interests of simpler and more conservative capital structures. And standards of fairness permit it. This was recognized in *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U. S. 445. This Court there said (p. 455) that though "to the extent of their debts creditors are entitled to priority over stockholders against all the property" of the debtor company, "it does not follow that in every reorganization the securities offered to general creditors must be superior in rank or grade to any which stockholders may obtain. It is not impossible to accord to the creditor his superior rights in other ways." And the Court went on to say (p. 456), "No offer is fair which does not recognize the prior rights of creditors . . . ; but circumstances may justify an offer of different amounts of the same grade of securities to both creditors and stockholders." Thus it is plain that while creditors may be given inferior grades of securities, their "superior rights" must be recognized. Clearly, those prior rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. That is not permissible. The plan then comes within judicial denunciation because it does not recognize the creditors' "equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation". *Kansas City Terminal Ry. Co. v. Central Union Trust Co., supra*, p. 454.

Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. As indicated in the *Boyd* case (228 U. S. at p. 508) the creditors are entitled to have the full value of the property, whether "present or prospective, for dividends or only for purposes of control", first appropriated to payment of their claims. But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on

²⁶ See. 77B(f)(1).

the facts and requirements of each case.²⁷ So long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court.

The Circuit Court of Appeals, however, made certain statements which if taken literally do not comport with the requirements of the absolute priority rule. It apparently ruled that a class of claimants with a lien on specific properties must receive full compensation out of those properties, and that a plan of reorganization is *per se*, unfair and inequitable if it substitutes for several old bond issues, separately secured, new securities constituting an interest in all of the properties. That does not follow from *Case v. Los Angeles Lumber Products Co., supra*. If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid. So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of "fair and equitable" are satisfied.

Any other standard might well place insuperable obstacles in the way of feasible plans of reorganization. Certainly where unified operations of separate properties are deemed advisable and essential, as they were in this case, the elimination of divisional mortgages may be necessary as well as wise. Moreover, the substitution of a simple, conservative capital structure for a highly complicated one may be a primary requirement of any reorganization plan. There is no necessity to construct the new capital structure on the framework of the old.

Affirmed.

²⁷ In view of the condition of the record relative to the value of the properties and the fact that the accrued interest is cancelled by the plan, it is not profitable to attempt a detailed discussion of the deficiencies in the alleged compensatory treatment of the bondholders. It should, however, be noted as respects the warrants issued to the old common stockholders that they admittedly have no equity in the enterprise. Accordingly, it should have been shown that there was a necessity of seeking new money from them and that the participation accorded them was not more than reasonably equivalent to their contribution. *Kansas City Terminal Ry. Co. v. Central Union Trust Co., supra*; *Case v. Los Angeles Lumber Products Co., supra*, pp. 121-122. In the latter case we warned against the dilution of creditors' rights by inadequate contributions by stockholders. Here that dilution takes a rather obvious form in view of the lower price at which the stockholders may exercise the warrants. Warrants exercised by them would dilute the value of common stock purchased by bondholders during the same period. Furthermore, on Consolidated's estimate of the equity in the enterprise, the values of the new common would have to increase many fold to reach a value which exceeds the warrant price by the amount of the accrued interest.